

<p>FINANCIAL ACCOUNTING 700</p> <p>Seminar RS 4 – Accounting policies, changes in accounting estimates and errors</p> <p><i>PH Ferreira</i></p>	<p>DEPARTMENT OF ACCOUNTING UP</p>
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Prescribed works:

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|----|---------------------------------------|---|------------------|
| 1. | IAS 8 | – | IASB |
| 2. | GAAP Handbook Volume 1
- Chapter 5 | – | Pretorius, et al |

Discussion class questions:

- Question A Change in estimate versus change in accounting policy
 Question B Change in policy, error, disclosable items

Questions:

		Time
Question 1	Calculations – change in accounting policy	± 20 min
Question 2	Prior period errors, disclosure	± 50 min
Question 3	Change in policy, error, disclosable items	± 45 min
Question 4	Change in policy, deferred tax	± 60 min

DISCUSSION CLASS QUESTIONS**QUESTION A**

- Inventory was valued on the FIFO basis in the past. In future, the weighted average cost method will be used.
- Provision for obsolete inventory was always based on 5% of the inventory value. As from now, the provision will be based on 7%, as this would lead to fairer presentation.
- Development expenditure was written off over 8 years in the past. After careful consideration, it was decided to write off the expenditure over 4 years in future.
- An entity, which used the cost model for its investment properties, now wants to change over to the fair value model.
- Change depreciation from the straight-line method to machine hour method.
- In the past depreciation on buildings was written off at 2% per annum. In order to ensure uniform accounting treatment in the group, the parent company issued a directive to all subsidiaries whereby this rate is changed to 2,5% per year for all buildings in the group.

REQUIRED:

Indicate in each case whether the above situations fit into the definition of a change in accounting estimate or a change in accounting policy.

QUESTION B

The following is an extract from the trial balance of Arend Limited for the year ended 30 June 20X6:

	20X6 Dr(Cr) R	20X5 Dr(Cr) R
Share capital	(10 000)	(10 000)
Net working capital (excluding inventory)	10 000	6 000
Profit on ordinary activities	(52 000)	(50 000)
Inventory	48 000	27 000
Value added tax	15 000	-
Machinery at carrying amount	27 000	36 000
Taxation on ordinary activities	20 800	20 000
Dividends paid	5 000	1 000
Retained earnings at beginning of year	(59 000)	(30 000)
Gross loss as a result of a cloudburst which damaged uninsured machinery (deductible for tax purposes - carrying amount equal to tax base)	20 000	-
Profit on sale of investment (assume not taxable)	(30 000)	-

Up to now the cost price of inventory had always been determined using the FIFO formula. **After** preparing the trial balance, the board of directors decided to change to the average cost formula with effect from the current financial year. The inventory valuations were as follows:

	20X4	20X5	20X6
Old method	19 500	27 000	48 000
New method	22 900	34 800	51 000
Difference	3 400	7 800	3 000
Tax effect @ 40%	(1 360)	(3 120)	(1 200)
	2 040	4 680	1 800
Net annual effect:			
- to 20X4	2 040		
- for 20X5		2 640	
- for 20X6			(2 880)

SARS is prepared to recognise the new method for tax purposes from 20X6. There are no temporary or other differences apart from those that are evident from the question. Capital gains tax and STC should be ignored.

The value added tax of R15 000 was paid in respect of 20X5 after inspectors picked up an underpayment of tax collected and issued an additional VAT assessment for 20X5. This underpayment resulted from output VAT incorrectly being charged to the sales account. SARS agreed to reopen the income tax assessment for 20X5 in respect of this issue.

The profit on ordinary activities is made up as follows:

	20X6 R	20X5 R
Sales	370 000	344 000
Cost of sales	(170 000)	(163 000)
Administrative expenses	(100 000)	(90 000)
Operating costs	(48 000)	(41 000)
	<u>52 000</u>	<u>50 000</u>

REQUIRED:

Prepare the statement of profit or loss and other comprehensive income of Arend Limited for the year ended 30 June 20X6. The statement of profit or loss and other comprehensive income should comply with International Financial Reporting Standards. Only the notes in respect of profit before tax, taxation, change in accounting policy and prior period errors are required. Also show the statement of changes in equity i.r.o. the retained earnings.

QUESTION 1

A Ltd currently recognises profits on HP-sales only once cash is received. For 20X2 and 20X1 the provision for unrealised profits included in outstanding instalments amounted to R160 000 and R120 000 respectively. In the current year (20X3) the company changed to an accounting policy according to which provision is made for unearned finance income on outstanding debtors. The new provision for 20X3 amounted to R65 000, but on the old basis it would have amounted to R195 000. If the new policy had been applied in 20X2 and 20X1, the provisions would have amounted to R50 000 and R40 000 respectively.

The taxation rate was 40% in 20X1 and 20X2, and 45% in 20X3.

REQUIRED:

- (a) Discuss briefly whether this change represents a change in accounting policy.
- (b) Calculate the following based on the change:
1. adjustment for the period to 20X1;
 2. the effect on profit after tax for 20X2;
 3. the effect on profit after tax for 20X3.

QUESTION 2

REK Ltd manufactures wooden windows and door frames. The company commenced business on 1 July 20X3.

The owners of the business are three Italians who immigrated to the RSA on a permanent basis in 20X3. The factory is located in the Rustenburg industrial area. At that stage (20X3) they had very little capital at their disposal and they were fortunate to lease a site with a building thereon, from the local authority.

All manufacturing machines were leased since incorporation at an amount of R40 000 per annum (paid in arrears - the first payment being on 30 June 20X4).

The inexperienced accountant prepared the following abridged statements of profit or loss and other comprehensive income for the years ended 30 June:

	Notes	20X6 R	20X5 R
Revenue		1 420 000	1 350 000
Cost of sales		(639 000)	(670 000)
Gross profit		781 000	680 000
Operating expenses	1	(641 000)	(555 000)
Profit before tax		140 000	125 000
Income tax expense @ 50 %	2	(70 000)	(62 500)
Profit after tax		70 000	62 500
Extraordinary items	3	(20 000)	-
Net profit for the period		50 000	62 500

The directors have decided, after the financial statements have been prepared, to change the accounting policy i.r.o finance leases. In the past these leases were not capitalised although this should have been done in accordance with International Financial Reporting Standards.

Additional information

1. The following was included in operating expenses:

	R
Distributing costs (20X5: R37 500)	43 000
Administrative expenses (20X5: R124 500)	121 000
Staff costs (20X5: R287 000)	333 000
Lease payments made	70 000
- land and buildings	30 000
- manufacturing machines (refer note 4)	40 000
Depreciation on office equipment	1 530
Donation to the UP (deductible for tax purposes)	300
Bank interest (20X5: R1 500)	1 850
Interest and foreign exchange differences on long-term loan (refer note 7)	54 500

2. Taxation was calculated by the accountant on the profit before taxation, multiplying it with the current tax rate of 50%, without taking into account any of the requirements of the Income Tax Act. Assume that the tax rate had been constant for the last few years. STC should be ignored.

3. The following items were treated as extraordinary items in the statement of profit or loss and other comprehensive income:

- Fine due to contravention of the Companies Act	R 5 000
- VAT paid	R15 000

(The VAT amount is payable in respect of the 20X4 book-year and relates to an underpayment of VAT collected, picked up by inspectors. This underpayment resulted from incorrectly charging output VAT to the sales account instead of the VAT account (output). VAT is levied on sales made directly to the public from the factory premises. The 20X4 tax assessment will be reopened regarding this matter.)

4. The lease agreement in respect of the manufacturing machinery offers the company the option to buy the machinery for R1 once the contract expires on 30 June 20X8. This is considered to be a finance lease.

The machinery has an expected useful life of 10 years with no scrap value. The original purchase price amounted to R135 000 on 1 July 20X3. The interest rate implicit to the lease is 14,714%.

5. An investigation of the minutes of directors' meetings presented the following issues that still had to be addressed:

- i. For the first time since incorporation of the company, an ordinary dividend of R15 000 was declared.

- ii. On 31 May 20X6 the company was sued by a major customer for R18 000. The client alleges that frames were not manufactured according to specifications. The board of directors will contest the case in court, but is uncertain what the outcome will be. The lawyers have indicated that the estimated legal costs until 30 June 20X6, regardless of the final verdict in the court case during September 20X6, will amount to R4 500. You can assume that this amount will be allowed by SARS for tax purposes in the current year.

6. It is the policy of the company to depreciate property, plant and equipment on the straight line basis over their expected useful lives. In the past SARS allowed the accounting deductions for tax purposes.

7. On 2 July 20X5 the company borrowed FC630 000 from a foreign country and received R1 400 000 in return. The loan is repayable in FC on 30 June 20X8. Interest is payable six-monthly in arrears at 15% per annum in FC on 31 December and 30 June. No FEC was taken out. SARS deems this loan to be utilised for operating purposes.

Applicable exchange rates are the following:

31/12/20X5	R1 = FC0,4725
30/06/20X6	R1 = FC0,50

[Assume for purposes of this question that interest should be translated at the spot rate on payment date, as average exchange rates are not available.]

8. On 1 July 20X4 retained earnings amounted to R100 000.

REQUIRED:

- Prepare the statement of profit or loss and other comprehensive income of the company for the year ended 30 June 20X6 in accordance with the requirements of International Financial Reporting Standards. Show all comparative amounts;
- Prepare the statement of changes in equity (with comparatives) for the year ended 30 June 20X6. Only the column relating to retained earnings is required;
- Prepare the following notes to the financial statements of REK Ltd. (Comparative amounts are not required in the notes, except when prior periods are restated.):
 - Profit before tax;
 - Income tax expense;
 - Prior period errors/changes in accounting policy.

QUESTION 3**(30 marks)**

The abridged statement of profit or loss and other comprehensive income of Aspatat Ltd for the year ending 30 June 20X8, is as follows:

	20X8 R'000	20X7 R'000
Revenue	800	700
Cost of sales	(430)	(370)
Gross profit	370	330
Operating costs	(250)	(220)
Dividends received	9	9
Profit before tax	129	119
Taxation	(36)	(44)
Profit/total comprehensive income for the year	93	75

Additional information

The following has not been taken into account in the statement of profit or loss and other comprehensive income of Aspatat Ltd:

- The board of directors decided on 30 June 20X8 to change the accounting policy iro inventory valuation from the FIFO method to the weighted average cost method. SARS will apply the new policy from 20X8 using normal tax practice.

Inventory according to the two methods are as follows:

	FIFO R	Average R
30 June 20X8	700 000	800 000
30 June 20X7	600 000	680 000
30 June 20X6	500 000	550 000
30 June 20X5	400 000	440 000
30 June 20X4	300 000	Cannot be determined

- On 30 April 20X8 the company sold land at a capital profit of R14 000. The directors do not want to show the amount separately on the "face" of the statement of profit or loss and other comprehensive income.
- On 28 February 20X8 the company suffered uninsured flood damages of R100 000 when a vehicle with a carrying amount of R100 000 was destroyed. The tax base of the vehicle was R70 000. (Assume that the carrying amount and tax base of the vehicle amounted to respectively R120 000 and R90 000 on 30 June 20X7, and R140 000 and R110 000 on 30 June 20X6.)

- A batch of sales invoices (goods sold on credit) with a total of R24 000 was accidentally not processed in 20X7. The cost of sales on these invoices, however, was taken into account. SARS reopened the 20X7 tax assessment in respect of this issue.
- Normal company taxation rate :

20X8	to 20X7
30 %	40 %
- Apart from those evident from the question, there are no other temporary differences.
- Capital gains tax should be ignored.
- Dividends paid amounted to R48 000 (20X7: R41 000).
- At the beginning of the 20X7 financial year, the balance of retained earnings was R66 000.

REQUIRED:

Prepare the statement of profit or loss and other comprehensive income and changes in equity statement (i.r.o. retained earnings) of Aspatat Ltd with comparative amounts as well as all relevant notes (excluding accounting policy notes) for the year ending 30 June 20X8 in accordance with International Financial Reporting Standards. Your answer should be based on the available information only.

[Round calculations to the first decimal in R'000, for example R25 780 = 25,8]

NOTE: Only notes to the statement of profit or loss and other comprehensive income and statement of changes in equity are required.

QUESTION 4**(40 marks)**

The following information relates to Zanzibar Ltd, a company with a financial year end of 31 December:

	20X2 Dr/(Cr) R	20X1 Dr/(Cr) R
<i>Statement of financial position accounts</i>		
Machinery	4 349 000	5 972 000
Cost – 1 January	9 110 000	10 000 000
Accumulated depreciation – 1 January	(4 761 000)	(4 028 000)
Inventory – 31 December	433 000	321 000
<i>Other accounts</i>		
Dividend declared	400 000	-

Additional information

1. The deferred tax liability was analysed as follows in the notes to the statement of financial position on 31 December 20X0:

	R
Machinery	704 900
Assessed loss	(525 000)
	<u>179 900</u>

2. On 1 March 20X1 a machine with an original cost of R890 000 was sold for R750 000. The carrying amount and tax base of the machine amounted to R697 167 and R600 750 respectively on that date. This matter has already been accounted for correctly in the accounting records.
3. On 1 July 20X2 a machine with an original cost of R1 200 000 was destroyed in a flood. An amount of R630 000 was received from the insurers. The carrying amount and tax base of the machine on the date that it was destroyed amounted to R660 000 and R390 000 respectively. This matter has already been accounted for correctly in the accounting records.

4. The accountant of Zanzibar Ltd already did the following tax calculation, which may be accepted as correct:

	20X2 R	20X1 R
Taxable income		
Accounting profit/(loss) before tax	1 709 000	(1 490 000)
Non-taxable/non-deductible differences:		
Dividends received	(150 000)	(101 000)
	1 559 000	(1 591 000)
Temporary differences:	(99 500)	(332 500)
Recoupment of machine	240 000	
Loss on machine destroyed	30 000	
Depreciation	851 000	925 833
Wear and tear	(1 276 500)	(1 388 750)
Profit on sale of machine	-	(52 833)
Recoupment on sale of machine	-	149 250
Prepaid expenses	50 000	(50 000)
Accrued leave liability	6 000	84 000
	<u>1 459 500</u>	<u>(1 923 500)</u>
Taxable income/(assessed loss)		

5. After completion of all the information above as well as the tax calculation, the directors of the company decided to change the inventory valuation method from the first-in-first-out method to the weighted average method, to facilitate fairer presentation. This change must already be effected in the financial statements for 20X2. The new inventory values are as follows:

	R
31 December 20X2	452 000
31 December 20X1	372 000
31 December 20X0	571 000

The inventory valuation amounted to R568 000 in the company's statement of financial position on 31 December 20X0. The South African Revenue Services indicated that the new policy will be accepted from 20X2.

6. The tax rate was 35% during 20X0. This rate decreased to 30% on 1 January 20X1. Since 20X0 there is uncertainty as to whether Zanzibar Ltd will have sufficient future taxable income to utilise debit balances on the deferred tax account.
7. VAT should be ignored.

REQUIRED:

Prepare the following notes to the financial statements of Zanzibar Ltd for the year ended 31 December 20X2, in terms of International Financial Reporting Standards:

- All tax notes;
- Profit before tax;
- Change in accounting policy.

- NOTE:**
- Accounting policy notes are not required.
 - Calculations should be rounded to the nearest Rand.